An Analysis of Tax Expenditure versus Direct Expenditure[1]

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1. Introduction

Each financial year concessions, benefits and incentives are delivered to taxpayers via the tax system. These concessions, benefits and incentives, referred to as tax expenditure, differ from direct expenditure because of the recurring fiscal impact without regular scrutiny through the federal budget process. There are approximately 270 different tax expenditures existing within the current tax regime with total measured tax expenditures in the 2005-06 financial year estimated to be around $42.1 billion, increasing to $52.7 billion by 2009-10. Each year, new tax expenditures are introduced, while existing tax expenditures are modified and deleted.

In recognition of some of the problems associated with tax expenditure, a Tax Expenditure Statement, as required by the *Charter of Budget Honesty Act 1988*, is produced annually by the Australian Federal Treasury. The Statement details the various expenditures and measures in the form of concessions, benefits and incentives provided to taxpayers by the Australian Government and calculates the tax expenditure in terms of revenue forgone. A similar approach to reporting tax expenditure, with such a report being a legal requirement, is followed by most OECD countries. The current Tax Expenditure Statement lists 270 tax expenditures and where it is able to, reports on the estimated pecuniary value of those expenditures.[2]

Apart from the annual Tax Expenditure Statement, there is very little other scrutiny of Australia's Federal tax expenditure program. While there has been various academic analysis of tax expenditure in Australia, when compared to the North American literature, it is suggested that the Australian literature is still in its infancy. In fact, one academic author who has contributed to tax expenditure analysis recently noted that there is 'remarkably little secondary literature which deals at any length with tax expenditures in the Australian context.'[3]

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1 Please note this paper is still a draft.

2 Australian Government, Treasury, *Tax Expenditures Statement 2006*, 2006, 2.

3 Burton, M, Making the Australian tax Expenditures Statement an Effective Policy Instrument – From Fiscal Record to Transparent Report, (2005) 8 *Journal of Australian Taxation*, 1 at 2.

Given this perceived gap in the secondary literature, this paper examines fundamental concept of tax expenditure and considers the role it plays in to the current tax regime as a whole, along with the effects of the introduction of new tax expenditures. In doing so, tax expenditure is contrasted with direct expenditure.

An analysis of tax expenditure versus direct expenditure is already a sophisticated and comprehensive body of work stemming from the US over the last three decades. As such, the title of this paper is rather misleading. However, given the lack of analysis in Australia, it is appropriate that this paper undertakes a consideration of tax expenditure versus direct expenditure in an Australian context. Given this proposition, rather than purport to undertake a comprehensive analysis of tax expenditure which has already been done, this paper discusses the substantive considerations of any such analysis to enable further investigation into the tax expenditure regime both as a whole and into individual tax expenditure initiatives. While none of the propositions in this paper are new in a 'tax expenditure analysis' sense, this debate is a relatively new contribution to the Australian literature on the tax policy.

Before the issues relating to tax expenditure can be determined, it is necessary to consider what is meant by 'tax expenditure'. As such, part two if this paper defines 'tax expenditure'. Part three determines the framework in which tax expenditure can be analysed. It is suggested that an analysis of tax expenditure must be evaluated within the framework of the design criteria of an income tax system with the key features of equity, efficiency, and simplicity.[4] Tax expenditure analysis can then be applied to deviations from the ideal tax base.[5]

Once it is established what is meant by tax expenditure and the framework for evaluation is determined, it is possible to establish the substantive issues to be evaluated. This paper suggests that there are four broad areas worthy of investigation; economic efficiency, administrative efficiency, whether tax expenditure initiatives achieve their policy intent, and the impact on stakeholders. Given these areas of investigation, part four of this paper considers the issues relating to the economic efficiency of the tax expenditure regime, in particular, the effect on resource allocation, incentives for taxpayer behaviour and distortions created by tax expenditures. Part five examines the notion of administrative efficiency in light of the fact that most tax expenditures could simply be delivered as direct expenditures. Part six explores the notion of policy intent and considers the two

[4] *Reform of the Australian Tax System (Draft White Paper)*, Canberra, AGPS, 1984, 14.

[5] This is commonly known as the 'benchmark income tax base' or alternatively the 'Schanz-Haig-Simons' base: Cooper, G, Krever, R, and Vann, R, *Income Taxation – Commentary and Materials*, 1989, 27.

questions that need to be asked; whether any tax expenditure initiative reaches its target group and whether the financial incentives are appropriate. Part seven examines the impact on stakeholders. Finally, part eight considers the future of tax expenditure analysis in Australia.

2. Tax Expenditure Defined

It is not possible to explore the topic of tax expenditure analysis without finding a reference to the late Professor Stanley Surrey. His seminal work has laid the foundation to all future writing on the topic.[6] Yet, the phrase 'tax expenditure' is a relatively new one, coined by Professor Surrey in 1967 when he was the Assistant Secretary of the Treasury for Tax Policy in the US.[7] Since then, healthy debate has ensued within North America on all aspects of tax expenditure analysis, including what exactly is meant by 'tax expenditure'.

For the purposes of this paper a very simple definition of tax expenditure is adopted. Tax expenditures cover a broad range of concessions administered through our tax system. Specifically, for reporting purposes in Australia, tax expenditure is defined as 'a tax concession that provides a benefit to a specified activity or class of taxpayer'.[8] Implicit in this definition is the fact that tax expenditures can be subcategorized into those aimed at a particular class of taxpayer (for example dependant rebates) and those aimed at a particular activity (for example, venture capital concessions). Generally, tax expenditures will be in the form of a tax exemption, tax deduction, tax offset, concessional tax rate or deferral of a tax liability. Although, interestingly in Australia, a number of recent initiatives administered through the tax system are not classified as tax expenditure but rather direct expenditure. For example, the Family Tax Benefit and the Private Health Insurance Tax Offset are not included in the statistical analysis of tax expenditure.[9]

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6 While Surrey first used the expression in 1967 his seminal work on tax expenditure was penned in Surrey, S S, *Tax Incentives as a Device for Implementing government Policy: A Comparison with Direct Government Expenditures*, (1970) 83 Harvard Law Review 705. See Also Surrey, S S, *Pathways to Tax Reform, The Concept of tax Expenditures*, (1973) Harvard University Press, Cambridge, Massachusetts.

7 Although Shaviro as suggests the notion of tax expenditures has been invented twice and was explored in Germany as early as 1954. Shaviro, D N, Rethinking Tax Expenditures and Fiscal Language, (2004) 57 Tax L. Rev. 187at 199. See also Babu, J, *The Tax Expenditure Budget: What the U.S. can learn from Germany*, (2002) 27 Seton Hall Legislative Journal, 163.

8 Australian Government, Treasury, *Tax Expenditures Statement 2006*, 2006, 1.

9 Australian Government, Treasury, *International Comparison of Australia's Taxes*, 12 April 2006, 14.1. Only programs which are considered integral to the tax system are treated as part of the tax system. The ABS uses the statistical concepts and classification principles of the IMF.

While the above description provides a definition of tax expenditure per se, they can also been seen as essentially a spending programs embedded into the tax regime.[10] In other words, tax expenditure initiatives are Government spending programs administered through the taxation system. In fact, Treasury documents state that '[t]ax expenditures are an alternative to direct expenditures as a method of delivering government assistance or meeting government objectives.'[11] The main difference between the two programs being that under a tax expenditure initiative, instead of giving money to the recipient, the recipient simply pays less tax.

Given that the Australian Treasury considers tax expenditure as an alternative to direct expenditure it is reasonable to assess tax expenditures on this basis. Hence, this paper considers the substantive issues in relation to tax expenditure as contrasted to direct expenditure.

Implicit in any direct contrast between a tax expenditure initiative and direct expenditure initiative is the assumption that the spending should occur and it is simply a question of mode of delivery. However, there is an underlying issue as to whether the expenditure should be incurred at all. Surrey and McDaniel describe this as the preliminary questions of need and design.[12] While this question is outside the scope of this paper, an assumption that the expenditure should be made by Government and it is simply a question of method should not necessarily be assumed. This is particularly in light of the fact that often, if a tax expenditure was reshaped into a direct expenditure, it is unlikely that it would be palatable in that form.

If tax expenditure is a tax concession which provides a benefit to a specified activity or class of taxpayer, the next question is 'what is tax expenditure analysis?' To this end, the current literature provides the answer. For example, Peroni describes the tax expenditure concept in tax policy analysis as follows:

> The idea is that tax code provisions that have a programmatic purpose (i.e., some economic or social policy purpose other than determining the taxpayer's net income subject to tax) should be treated as government programs that need to be identified, quantified, and evaluated under a rigorous cost-benefit analysis. A significant purpose

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[10] Surrey, S S and McDaniel P R, Tax Expenditures, Harvard University Press, Cambridge Massachusetts, 1985, 1.

[11] Australian Government, Treasury, *Tax Expenditures Statement 2006*, 2006, 2.

[12] Surrey, S S and McDaniel P R, Tax Expenditures, Harvard University Press, Cambridge Massachusetts, 1985, 112.

> of the tax expenditure analysis is to bring transparency to government programs advanced through the tax system, recognizing that these indirect government programs often pass under the radar screen with far less scrutiny than direct government programs receive. [13]

It was noted earlier that very little tax expenditure analysis has been undertaken in Australia. Yet, in the US it appears to have gone full circle. Again, noting the comments of Peroni: 'It has become fashionable in academic and government circles to bash the tax expenditure concept as outdated, simplistic, and lacking analytic value.'[14] In response to this notion that tax expenditure analysis is outdated, he states:

> These criticisms largely miss the point of the tax expenditure concept. The major point is that if a government program to be administered through the tax system is being proposed everyone ought to understand that is what is being done and the program should undergo the same scrutiny as would any direct government program. If the program cannot satisfy a rigorous cost-benefit analysis, it should not be enacted or should be terminated if it has already been enacted. Part of that calculus involves a serious determination of whether it makes sense to accomplish the program through the tax system, rather than through some other government mechanism. The fact that the government program masquerades as a technical tax provision in a complicated tax bill should not change the level of scrutiny that the proposed program will receive. The point is not that the taxpayer's income belongs to the government, but, instead, that tax expenditures constitute funds spent on a government program and ought to be carefully evaluated as such.[15]

The purpose of this paper in relation to tax expenditure analysis, as Peroni suggests, is not to critique the model itself, but rather to invigorate debate in Australia as to what is being done in relation to our tax expenditure initiatives and to consider whether they undergo the same scrutiny as our direct expenditure initiatives. To do this it is necessary to consider the tax base from which we apply a cost-benefit analysis. Part three of this paper discussed the notion of the tax base.

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[13] Peroni R J , Tax reform Interrupted: The Chaotic State of tax Policy in 2003, (2004) 34 McGeorge Law Review, 277 at 315-316.

[14] Peroni R J , Tax reform Interrupted: The Chaotic State of tax Policy in 2003, (2004) 34 McGeorge Law Review, 277 at 315-316.

[15] Peroni R J , Tax reform Interrupted: The Chaotic State of tax Policy in 2003, (2004) 34 McGeorge Law Review, 277 at 316-317.

3. The Tax Base

An analysis of tax expenditure as a whole and, in particular, any individual tax expenditure initiative requires an estimate of the value of that expenditure to establish the nature and extent of the concession/s. Both theoretical and statistical analysis of tax expenditure relies on a benchmark or tax base to measure deviations. In Australia, the Tax Expenditure Statement specifically states that the analysis requires benchmarking of the 'normal' tax treatment and measuring for deviations from that benchmark.[16] Tax expenditure analysis can then be applied to deviations from the ideal tax base.[17]

Surrey and McDaniel explain:

> The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. These provisions comprise the revenue-raising aspects of the tax. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class of persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.[18]

Implicit in the above statement is the fact that Surrey and McDaniel do not favour a tax model which contains tax expenditures. The model of the tax system described above by

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16 Department of Treasury, *Tax Expenditure Statement 2006*, http://www.treasury.gov.au, 2.

17 This is commonly known as the 'benchmark income tax base' or alternatively the 'Schanz-Haig-Simons' base: Cooper, G, Krever, R, and Vann, R, *Income Taxation – Commentary and Materials*, 1989, 27.

18 Surrey, S S and McDaniel P R, Tax Expenditures, Harvard University Press, Cambridge Massachusetts, 1985, 3.

Surrey and McDaniel is not without its adversaries and the tax expenditure concept has been critiqued by some who suggest it is flawed.[19] Some commentators have gone so far as to suggest a new theory of tax expenditure. For example, Weisbach and Nussim suggest that 'the decision to implement a "non-tax" program through the "tax system" has little or nothing to do with tax policy. Instead, the tax expenditure decision, which we will also call the integration decision or the decision to combine tax and spending programs, is solely a matter of institutional design.'[20] They go on to argue that 'it is entirely irrelevant whether some piece of government policy complies with independent tax norms.'[21] However, to date this theory has not gained favour. Consequently, for the purposes of this paper it is accepted that the Surrey model provides a suitable framework to determine the considerations within the Australian context.

Once it is established that tax expenditures are evaluated as deviations from the normal tax base it is suggested that an analysis of tax expenditure must be evaluated within the framework of the design criteria of an income tax system with the key features of equity, efficiency, and simplicity[22] To that end, the annual Federal Tax Expenditure Statement makes it clear that the reporting of tax expenditures is designed to assist in determining whether there has been adherence to these three key principles of tax system design.[23] It has been suggested that such a report allows tax expenditures a similar degree of scrutiny as direct expenditures as well as allowing for a more comprehensive assessment of the activities of the government and the promotion and assistance of public debate on this element of the tax system.[24] Burton, in his 2005 article on Tax Expenditure Statements mounts a compelling case for the negative and argues for the improvement of these annual Statements to satisfy the aims.[25] As such, specific flaws of the Tax Expenditure Statement are not re-explored in this paper. However, implicit in the discussion below is the view that the Tax Expenditure Statement does not adequately assess the current tax expenditure regime. Nor is there currently any formal process for assessing proposed tax expenditure measures.

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19 See Infanti, A C, A *Tax Crit Identity Crisis? Or Tax Expenditure Analysis, Deconstruction, and the rethinking of a Collective Identity,* (2005)26 Whittier Law Review, 707 for a review of the critiques made by academics and non-academics.

20 Weisbach, D A, and Nussim, J, *The Integration of Tax and Spending Programs,* (2004) 113 Yale Law Journal, 955 at 955.

21 Weisbach, D A, and Nussim, J, *The Integration of Tax and Spending Programs,* (2004) 113 Yale Law Journal, 955 at 958.

22 *Reform of the Australian Tax System (Draft White Paper),* Canberra, AGPS, 1984, 14.

23 Department of Treasury, *Tax Expenditure Statement 2006,* http://www.treasury.gov.au, 4.

24 Australian Government, Treasury, *Tax Expenditures Statement 2006,* 2006, 2.

25 Burton, M, *Making the Australian tax Expenditures Statement an Effective Policy Instrument – From Fiscal Record to Transparent Report,* (2005) 8 Journal of Australian Taxation, 1

The next step is to undertake this evaluation of tax expenditure as deviations from the normal tax base. Stated in less theoretical terms and in accordance with Federal Treasury policy on the assessment of tax expenditure, the introduction of a new benefit requires a consideration of any effect on resource allocation, the most appropriate way to administer any concessions, whether policy intent will be achieved and the impact on the relevant stakeholders.[26] Within these four considerations, equity, efficiency and simplicity can be considered.

4. Economic efficiency

The first consideration in relation to a tax expenditure initiative is whether it is economically efficient to introduce the proposed measure through tax expenditure rather than direct expenditure. This requires an analysis of its effect on resource allocation, incentives for taxpayer behaviour and distortions created by tax expenditures.

It is arguable that the biggest problem associated with tax expenditures in relation to economic efficiency, considering the amount of revenue foregone, is that tax rates are kept higher than necessary as revenue raised is reduced and the tax base is narrowed.[27] Any increase in tax expenditure necessarily requires an increase in revenue raised from non-beneficiary taxpayers. This effect impinges on all taxpayers. While direct expenditure may require the same amount of revenue forgone, it may be the case that the expenditure would not be introduced at all if the only means was via direct expenditure. As stated above, this is the preliminary question of need. In addition to this overarching effect on economic efficiency, there are issues that arise as a result of individual tax expenditures.

Neutrality, or economic efficiency is a principle characteristic of an efficient tax system, whereby relative rates of return do not vary between alternate investments.[28] The introduction of a tax expenditure aimed at a particular activity or industry is likely to fail to satisfy this criteria of an efficient tax system. In fact, by design, tax expenditures are

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26 Department of Treasury, *Tax Expenditure Statement 2006*, http://www.treasury.gov.au, 4.

27 Surrey, S S, *Pathways to Tax Reform, The Concept of tax Expenditures*, (1973) Harvard University Press, Cambridge, Massachusetts, 139.

28 Cooper, G, Krever, R, and Vann, R, *Income Taxation – Commentary and Materials*, 1989, 23.

often intended to favour one investment strategy over another, a point which Surrey acknowledges.[29] Surrey describes the effect on equity as follows:

> It is clear then, that most tax incentives have decidedly adverse effects on equity as between taxpayers at the same income level, and also, with respect to individual income tax, between taxpayers at different income levels. As a consequence of these inequitable effects, many tax incentives look, and are, highly irrational when phrased as direct expenditure programs structures the same way.[30]

Surrey argues that there is a distortion in the possible taxpayer choices driven by the fact that tax incentives, by design, are intended to favour certain behaviour or investment strategy over another means. This also as Surry describes produces "unneutralities in the allocation of resources."[31]

In the discussion above it is necessarily assumed that the tax incentive is aimed at particular taxpayers or activities and that the design of the expenditure produces the desired result, albeit leading to economic distortion. However, it may be argued that this is a best case scenario. As there is currently no assessment or design model for the introduction of a tax expenditure it is often the case that taxpayers or activities outside the target are recipients of the benefits of the tax expenditure. As Krever states '[i]n many cases tax expenditures are adopted with no attempt to define or delineate the activities or investments that will enjoy concessional treatment.'[32] Therefore, tax expenditure initiatives may reach taxpayers beyond the intended beneficiaries.

Two further problems with tax expenditures affecting economic efficiency is that of rent-seeking and of windfalls. It is first necessary to evaluate whether a tax expenditure initiative simply constitutes rent-seeking as opposed to good public policy.[33] Tax expenditures are often introduced due to the lobbying of certain powerful and influential taxpayers. We often see the promise of tax incentives around election times and where this occurs we need to ask whether it is the power of these taxpayers (or alternatively the

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[29] Surrey, S S, *Pathways to Tax Reform, The Concept of tax Expenditures*, (1973) Harvard University Press, Cambridge, Massachusetts, 138.

[30] Surrey, S S, *Pathways to Tax Reform, The Concept of tax Expenditures*, (1973) Harvard University Press, Cambridge, Massachusetts, 136.

[31] Surrey, S S, *Pathways to Tax Reform, The Concept of tax Expenditures*, (1973) Harvard University Press, Cambridge, Massachusetts, 138.

[32] Krever, R, *Taming the Complexity in Australian Income Tax*, (2003) 25 Sydney L. Rev. 467 at 489.

[33] Roin, J, Truth in Government: Beyond the Tax Expenditure Budget, 54 Hastings L.J. 603 at 605.

lure of the tax incentives for the taxpayers) that leads to the introduction of a tax incentive rather than sound public policy. Where this occurs there is the implicit unfairness of the activity that raised efficiency concerns.[34] Secondly, it is arguable, that, unless tax incentives are well designed, they simply reward taxpayers for undertaking behaviour that they would undertake nevertheless. Surrey describes these tax incentives as "windfalls by paying taxpayers for doing what they would do anyway."[35]

In addition to the question of economic efficiency, it is necessary to consider whether it is administratively efficient to introduce a spending measure via tax expenditures rather than direct expenditures. The next part of this paper addresses the issue of administrative efficiency.

5. Administrative Efficiency

The second consideration in relation to a tax expenditure initiative is whether it is administratively efficient to introduce the proposed measure through tax expenditure rather than direct expenditure. That is, the most appropriate way to administer concessions needs to be investigated.

As a purely practical matter it is foreseeable that a tax expenditure is more administratively efficient than a direct expenditure. An argument can be mounted that it is more administratively efficient to simply reduce the amount collected from a taxpayer, than to collect the full amount of tax and then provide a payment back to those who qualify for the concession. Related to this argument is the notion that tax expenditure compared to direct expenditure reduces the amount of direct government supervision required. In fact, in the 2006 Treasury Report on the *International Comparison of Australia's Taxes* it was stated as a positive that a tax expenditure initiative, rather than direct expenditure, reduces the amount of direct government supervision required of any policy.[36] However, these arguments rely on key assumptions. First, it assumes that it is desirable to have an efficient governmental administrative system at the expense of an efficient tax administrative system. Secondly, it assumes that the assessment of tax expenditures is best done within the framework of taxation.

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34 Roin, J, Truth in Government: Beyond the Tax Expenditure Budget, 54 HASTINGS L.J. 603 at 605.

35 Surrey, S S, *Pathways to Tax Reform, The Concept of tax Expenditures*, (1973) Harvard University Press, Cambridge, Massachusetts, 134.

36 Australian Government, The Treasury, *International Comparison of Australia's Taxes*, 12 April 2006, 14.1.

The first assumption requires us to consider whether the question of administrative efficiency is one directed at the level of overall governmental administrative efficiency or administrative efficiency within the tax system. While it is arguable that overall efficiency may be achieved with tax expenditure measures, the increase in complexity via the introduction of a concessionary regime must be weighed against the key criteria of simplicity within the tax system.

If simplicity within the tax system is a goal, it is argued that it is not achievable if the current tax expenditure regime remains part of the tax system. As Surrey and McDaniel state '[t]ax simplification will be impossible if these tax expenditures persist.'[37] They go on to explain that with respect to administration, the burden of the normative income tax is difficult and complex. When the burden of administering the tax expenditures program is added the system is potentially overloaded.[38] This point has not gone unnoticed in Australia. The increased complexity because of tax expenditures was recognised in the Draft White Paper in 1985.[39]

This particular issue relating to tax expenditures was addressed by Krever in 2003 in his article addressing the complexity problems associated with the current Australian income tax regime. He stated:

> Using, or more accurately, misusing the income tax law as a spending vehicle is undoubtedly one of the largest sources of complexity in the legislation. It has proved impossible to deliberately distort investment or consumption behaviour by lowering the tax burden on preferred activities and not invite abuse. Tax law never specifies the intended recipients of concessions; at best it seeks to define the types of transactions or investments that will qualify for tax expenditures. However tightly the boundaries of desired activities and assets are defined, it is inevitable that they will be breached by well advised taxpayers recharacterising transactions and investments to qualify for the subsidies. This activity, in turn, will lead to complex anti-avoidance measures intended to protect the integrity of the original subsidy scheme. The new legislation will lead to further planning which will lead to further legislation, and the cycle

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37 Surrey, S S and McDaniel P R, Tax Expenditures, Harvard University Press, Cambridge Massachusetts, 1985, 26.

38 Surrey, S S and McDaniel P R, Tax Expenditures, Harvard University Press, Cambridge Massachusetts, 1985, 26.

39 Commonwealth of Australia, *Reform of the Australian Tax System, Draft White Paper,* AGPS (1985), 11.

> will continue for many years until either the concession is abandoned or is buried within dozens of complex anti-avoidance provisions.[40]

It is possible to see one potential administrative benefit to tax expenditure programs in the limited situations. Again this is a purely practical matter and will be relevant where the tax expenditure benefit to the taxpayer is reliant on means testing.[41] The ATO has the information and expertise to assess a taxpayer's income. However, the question is whether this particular benefit outweighs the overall administrative burden of overseeing the tax expenditure initiative in the first place.

The second assumption underlying the argument that the tax system is a more appropriate administrative regime for expenditure is that the assessment of expenditures should be undertaken via the tax regime. This is a question of scrutiny and public accountability, which is always contentious in relation to tax expenditures. This problem was recognised in an Australian Treasury report in 2006 when it was stated that there is a lower level of public accountability as compared to direct expenditures which are scutinised as part of the annual budget.[42] As Barkoczy and Sandler point out, there are also accountability issues due to a perception that tax expenditures are not monitored as closely as direct expenditures. Put simply, tax expenditures are not as obvious as direct expenditures and, unless extremely large, simply go unnoticed.

The question then is to how we should be evaluating tax expenditure. When we defined tax expenditure earlier in the paper, the point was made that tax expenditure initiatives have some programmatic purpose, that is, they have an economic or social purpose rather than being part of the tax system to determine the net income of the taxpayer. Given that a tax expenditure initiative is designed to achieve a public policy goal as opposed to a revenue raising purpose it is analogous to the spending of public money. By extrapolation, the criteria for evaluation should then be those applied to public spending. It is arguable that this is difficult to do if tax expenditures remain part of the tax system.

Related to the issue of scrutiny and accountability is the way they are evaluated. Critics of tax expenditure initiatives suggest that tax expenditures are evaluated differently because they are usually open ended (no built in cost limits), there is no evaluation of

40 Krever, R, *Taming the Complexity in Australian Income Tax*, (2003) 25 Sydney L. Rev. 467 at 488.

41 Stead, M M, Implementing Disaster Relief through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures, (2006) 81 New York University Law Review, 2158 at 2174.

42 Australian Government, The Treasury, *International Comparison of Australia's Taxes*, 12 April 2006, 14.1.

recipient worthiness (a taxpayer simply fills in a tax return), there is generally little or no assessment of their effectiveness, and the beneficiaries along with their use of the subsidy is largely unknown.[43]

Economic and administrative efficiency of the tax expenditure regime are likely to draw the most criticism. However, it has been recognised in Australia that 'ancillary to the accountability and transparency issues associated with tax expenditures there is the difficulty in setting the tax expenditure initiative at the correct level and desired group to achieve the particular social policy objectives.'[44] As such, the next part of this paper addresses the problems associated with tax expenditure initiatives achieving policy intent.

6. Achieving Policy Intent

The third consideration in relation to a tax expenditure initiative is whether introduction via tax expenditure rather than direct expenditure achieves greater parity with the intent of the policy behind the expenditure initiative. That is, it is necessary to investigate whether the policy intent to provide concessions through the tax system will be achieved. At the outset it must be remembered that tax expenditures are designed to achieve public policy objectives that have little or nothing to do with the main objective of our tax system, the collection of revenue. The question, therefore, of whether public policy intent is achieved is twofold: first, does the tax expenditure initiative reach its target group and only it's target group and secondly, are the financial incentives sufficient to achieve the desired goals or alternatively, too liberal and therefore unnecessarily costly.

The first question of whether the tax expenditure initiative reaches its target group and only its target group requires a consideration of the purpose of the initiative. If the initiative is designed to provide a concession or subsidy to certain taxpayers, for example, low income earners, the question must be asked whether it does in fact reach low income earners and only low income earners. That is, if a policy decision is made to provide assistance to certain classes of taxpayers, do those taxpayers, and those taxpayers only, benefit from the particular tax expenditure program? Alternatively if the initiative is directed towards a particular activity, the question must be asked whether it is only that activity which receives the benefit of the tax expenditure initiative. That is, if the policy

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43 Institute on Taxation and Economic Policy, *Tax Expenditures: Spending by Another Name*, Policy Brief #4, 2005.

44 Australian Government, The Treasury, *International Comparison of Australia's Taxes*, 12 April 2006, 14.1.

decision is made to rigorously encourage certain behaviour, do tax concessions achieve this goal?

The main reason that policy intent may not be achieved, particularly where the tax expenditure is aimed at a particular class of taxpayer, is what is known as the 'upside-down' effect. The upside-down effect of tax expenditures defeats the policy intent of individual tax expenditure initiatives because taxpayers with the greatest need get the least assistance and those in less need are given greater assistance.[45] This is due largely to our progressive rates of tax and the fact that often the value of the concession to the taxpayer is dependent on the taxpayer's rate of tax.[46] Where this effect is present it defeats the overall policy intent of any progressive tax regime. Each tax expenditure initiative needs to be individually assessed to determine whether it has this effect. However, Surrey states that '[t]his criticism – that tax incentives produce inequitable effects and upside-down benefits – is valid as to the general run of tax incentives.'[47]

In the US, literature does investigate the effect of individual tax expenditure initiatives. One such example is contained in the recent academic literature emanating from the US which argues that tax expenditures do not achieve their policy intent, highlighted through disaster relief programs, particularly in the aftermath of Hurricane Katrina.[48] In summary, this literature argues that 'in a disaster, both the vulnerability of lower-income taxpayers and the weakness of the Internal Revenue Code as an instrument for social programs are amplified.'[49]

The second question is whether the financial incentives are sufficient to achieve the desired goals or alternatively, too liberal and therefore unnecessarily costly. This is a matter of legislative drafting to ensure that the tax expenditure initiative is appropriately

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45 Surrey, S S and McDaniel P R, Tax Expenditures, Harvard University Press, Cambridge Massachusetts, 1985, 3. Barkoczy, S and Sandler, D, *Government Venture Capital Incentives, A Multijurisdiction Comparative Analysis*, Australian Tax Research Foundation, Research Study No 46 (2007), 32.

46 Barkoczy, S and Sandler, D, *Government Venture Capital Incentives, A Multijurisdiction Comparative Analysis*, Australian Tax Research Foundation, Research Study No 46 (2007), 32.

47 Surrey, S S, *Pathways to Tax Reform, The Concept of tax Expenditures*, (1973) Harvard University Press, Cambridge, Massachusetts, 136.

48 See for example, Stead, M M, Implementing Disaster Relief through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures, (2006) 81 New York University Law Review, 2158 and Woellner, A, Spending on an Empty Wallet: A Critique of Tax Expenditures and the Current Fiscal Policy, (2006) 7 Houston Business & Tax Law Journal, 201.

49 Stead, M M, Implementing Disaster Relief through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures, (2006) 81 New York University Law Review, 2158, at 2158.

implemented. The comments by Krever noted earlier in the paper, suggest that the current system demonstrates that this is an almost impossible task. Contributing to this question is the issue of whether the tax expenditure merely compensates for behaviour which would have been undertaken at any rate. Where taxpayers would undertake certain behaviour irrespective of a tax expenditure initiative, the tax expenditure can simply be characterised as a windfall in the hands of those taxpayers.[50]

The outcome of tax expenditure programs is difficult to predict, and certainly more difficult than direct expenditure programs.[51] This is because 'it is not entirely certain how many taxpayers may change their behavior in order to take advantage of a tax break, and since, unlike direct expenditures, tax exemptions usually do not require an annual evaluation and approval process, the amount of forgone revenue is unknown.'[52] Overall, it would appear more difficult to achieve the policy intent of a 'spending' program where it is implemented through the tax expenditure regime rather than direct expenditure.

Whether or not a tax expenditure initiative achieves its policy intent, there will be an impact on stakeholders. The next part of this paper considers this impact.

7. Impact on Stakeholders

The fourth consideration in relation to a tax expenditure initiative is the impact that initiative will have on stakeholders. The impact on different stakeholders within the economy needs to be investigated, particularly as tax expenditures shift the tax burden to entities that are not treated concessionally. To achieve equity within a tax system, taxpayers with economically similar circumstances should not be faced with significantly different burdens. Further, taxpayers returning greater income should bear a larger burden of tax. Any impact of proposed concessions must be examined to ascertain any deviation from the criteria of horizontal and vertical equity.

Before discussing the impact on various stakeholders, an overarching consideration in relation to tax expenditures is the difficulty in evaluating them at all. It has previously

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50 Barkoczy, S and Sandler, D, *Government Venture Capital Incentives, A Multijurisdiction Comparative Analysis*, Australian Tax Research Foundation, Research Study No 46 (2007), 36.

51 Stead, M M, Implementing Disaster Relief through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures, (2006) 81 New York University Law Review, 2158 at 2172.

52 Stead, M M, Implementing Disaster Relief through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures, (2006) 81 New York University Law Review, 2158 at 2172.

been discussed that little information is provided on tax expenditures and they do not undergo the same scrutiny as direct expenditures. In practical terms tax expenditures tend to be less visible than other public spending which makes it harder for stakeholders to evaluate the concessions.[53] In addressing this question Burton, in his 2005 paper on Tax Expenditure Statements, asks the question whether more information should be provided if the interests of the stakeholders are to be met.[54] This may simply improve the perception of fairness in our tax system. As pointed out in the Draft White Paper, tax expenditures can contribute to this perception that the current tax regime is unfair.[55]

In addition to the issue of visibility is the issue of perception. Most people regard the current tax regime as a revenue raising instrument. However, very few people would view it as a means by which the Federal Government also spends money. As Surrey and McDaniel suggest '[a] clear understanding of this fact is essential if an informed public is to be able to consider intelligently the total impact of government spending both on the economy and on particular groups of people or businesses.'[56] Without this knowledge of what tax expenditures are, stakeholders are not able to accurately assess the impact of any measures.

The stakeholders in the tax expenditure regime include the taxpayers who benefit from the tax expenditure measures, the Australian Tax Office and the Federal Government, non-beneficiary taxpayers and the community as a whole. Burton expands the stakeholders to even include the tax profession, and the national and international finance communities.[57] Each class of stakeholder will have different interests or concerns. However, given the large amount of spending involved each stakeholder should be concerned. When talking about the revenue forgone as stated in the Tax Expenditure Statement Burton makes the comment '[c]learly, with this much at stake, there is good reason for the Government and members of the public alike to query whether it is receiving value for money from this massive "spending" program.'[58]

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[53] Australian Government, The Treasury, *International Comparison of Australia's Taxes*, 12 April 2006, 14.1.

[54] Burton, M, Making the Australian tax Expenditures Statement an Effective Policy Instrument – From Fiscal Record to Transparent Report, (2005) 8 *Journal of Australian Taxation*, 1 at 5.

[55] Commonwealth of Australia, *Reform of the Australian Tax System, Draft White Paper*, AGPS (1985), 32.

[56] Surrey, S S and McDaniel P R, Tax Expenditures, Harvard University Press, Cambridge Massachusetts, 1985, 1.

[57] Burton, M, Making the Australian tax Expenditures Statement an Effective Policy Instrument – From Fiscal Record to Transparent Report, (2005) 8 *Journal of Australian Taxation*, 1 at 4.

[58] Burton, M, Making the Australian tax Expenditures Statement an Effective Policy Instrument – From Fiscal Record to Transparent Report, (2005) 8 *Journal of Australian Taxation*, 1 at 2.

It is likely that the most interested stakeholders are those who are beneficiaries or potential beneficiaries of the tax expenditure initiative. These taxpayers are likely to have a greater knowledge of the benefits associated with the initiative and generally being self seeking or rent seeking taxpayers they are likely to seek tax concessions through political channels.[59] Further, different lobby groups, as well as having competing interests, may directly compete for tax concessions. The corollary to this is Government reaction to the demands of rent seeking taxpayers. As Krever explains '…Governments regularly intervene in the market with a range of subsidy programs to alter the allocation of investment and consumption. Added to the economic aims of subsidies is the inevitable objective of seeking friends and winning votes in marginal seats through corporate and individual welfare handouts.'[60] However, given the nature of tax expenditures there is decreased transparency to voters of tax expenditures as compared to direct outlays.[61]

Both the beneficiary taxpayers and the Governments using tax expenditures as a means of 'spending' appear to prefer this over direct expenditure. As Krever explains:

> Increasingly, Australian governments have relied on tax expenditures in preference to direct expenditures to carry out their subsidy programs. They are accounted for in an annual tax expenditure budget but because they do not require annual appropriation bills as do direct expenditures, handouts through the tax system are far less transparent and far more immune from public scrutiny than direct expenditures. This is seen as their most positive feature by governments and the beneficiaries of tax-based subsidies since often the recipients of tax expenditures adopt public positions opposing increased government spending or subsidy programs.[62]

The non-beneficiaries of tax expenditure measures are then faced with the consequences of these 'spending' programs. It was discussed earlier that the tax base is narrowed by tax expenditures as the burden of tax is born by those not receiving benefits. However,

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59 Burton, M, Making the Australian tax Expenditures Statement an Effective Policy Instrument – From Fiscal Record to Transparent Report, (2005) 8 *Journal of Australian Taxation*, 1 at 2.

60 Krever, R, *Taming the Complexity in Australian Income Tax*, (2003) 25 Sydney L. Rev. 467 at 488.

61 Stead, M M, Implementing Disaster Relief through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures, (2006) 81 New York University Law Review, 2158 at 2171.

62 Krever, R, *Taming the Complexity in Australian Income Tax*, (2003) 25 Sydney L. Rev. 467 at 488.

the cost of this is less visible to taxpayers in general and the community as a whole as compared to direct spending. This is 'in part because it is easier to understand straightforward spending than the possible effect of a particular tax provision.'[63]

Given that it is difficult to see many benefits associated with tax expenditure versus direct expenditure, and the fact that despite this, they are unlikely to diminish in terms of revenue forgone, the question that needs to be asked is what do we do with this information.

8. The Future of Tax Expenditure Analysis in Australia?

This paper does not contain a conclusion for the simple reason that no conclusion can be drawn from the ideas contained within. Rather, as stated in the introduction, the purpose of this paper is to discuss the substantive considerations of any tax expenditure analysis within Australia. We are fortunate because much of the work has been done in the US. We also know from the US experience that '[w]hile tax expenditure analysis has been enormously successful as a procedural program, it has largely been unsuccessful in substantive terms, failing to curb legislatures' use of tax systems for expenditure type programs.'[64] It is unlikely that Australia will adopt an approach any different. As Barkoczy and Sandler state:

> Despite the many concerns that exist in relation to tax expenditure programs, governments around the world continue to implement them, and indeed rely heavily on them as social and economic engineering devices. The Australian Government is no exception; it has introduced many different kinds of tax expenditure programs over the years, including a range of superannuation, research and development, film investment and infrastructure project incentives.[65]

Given this assessment, the question that needs to be considered by Government each time financial assistance is provided to a specific category of taxpayers or a specific activity is

[63] Stead, M M, Implementing Disaster Relief through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures, (2006) 81 New York University Law Review, 2158 at 2171.

[64] Zelinsky, E A, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis,* (2005) I24 Va. Tax rev. 797 at 798.

[65] Barkoczy, S and Sandler, D, *Government Venture Capital Incentives, A Multijurisdiction Comparative Analysis,* Australian Tax Research Foundation, Research Study No 46 (2007), 33.

whether that assistance should be offered through the tax system as tax expenditure or via direct expenditure. If tax expenditure programs continue to be employed over direct expenditure programs it is necessary at implementation stage to consider the design features of individual schemes. It may be the case that a base model can be ascertained to evaluate any proposed expenditure. However, the type of tax incentive offered, that is whether for a particular category of stakeholders or a particular activity, may determine any specific considerations that need to be undertaken.

Very little has been written on these considerations. However, Barkoczy and Sandler consider the main areas that need to be addressed in implementing tax expenditure initiatives aimed at supporting venture capital investment.[66] They list eight specific areas for consideration: regulation, registration, beneficiaries, nature of the incentives, investee company criteria, investment criteria, capping and the relationship to other programs.[67] Obviously, different tax expenditure initiatives would require a consideration of different factors.

Tax expenditures need to be considered in the context of both budget policy issues and tax policy issues. Where tax expenditures already exist, they need to come under similar scrutiny to direct expenditures as outlined above. Greater analysis of tax expenditures would be facilitated by the provision of further information as part of the Tax Expenditure Statement. For example, it has been suggested that a statement as to the ultimate beneficiaries, an indication of the accuracy of the amount of revenue foregone, and whether the tax expenditure falls within an established international norm.[68]

There is no doubt that the annual Tax Expenditure Statement plays an important role within our governmental processes.[69] However, the information provided in the Statement is limited to an overview of the Australian Government tax expenditures, changes to the list of tax expenditures, and details of each tax expenditure including an estimate (where possible) of the benefit taxpayers derive, a description of the tax expenditure, a legislative reference and the date the expenditure was introduced.[70] The

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66 Barkoczy, S and Sandler, D, *Government Venture Capital Incentives, A Multijurisdiction Comparative Analysis,* Australian Tax Research Foundation, Research Study No 46 (2007), 37.

67 Barkoczy, S and Sandler, D, *Government Venture Capital Incentives, A Multijurisdiction Comparative Analysis,* Australian Tax Research Foundation, Research Study No 46 (2007), 39-40.

68 Burton, M, Making the Australian tax Expenditures Statement an Effective Policy Instrument – From Fiscal Record to Transparent Report, (2005) 8 *Journal of Australian Taxation,* 1 at 31.

69 Burton, M, Making the Australian tax Expenditures Statement an Effective Policy Instrument – From Fiscal Record to Transparent Report, (2005) 8 *Journal of Australian Taxation,* 1 at 2.

70 Australian Government, Treasury, *Tax Expenditures Statement 2006,* 2006, 5.

Statement does not go any further to consider the policy driving the tax expenditure beneficiaries of the tax expenditure initiatives.

Surrey and McDaniel made the following statement over 20 years ago: 'The task of educating the taxpaying public and its elected representatives about the tax expenditure concept and the effects of those expenditures on budget efficiency and tax equity is both necessary and ongoing.'[71] It seems that in Australia we may have a valid reason for embracing this idea.

[71] Surrey, S S and McDaniel P R, Tax Expenditures, Harvard University Press, Cambridge Massachusetts, 1985, 30.